

MARKETS & MORE



CROSS ASSET CORRELATION

What is It and What Does it Do?

Cross Asset Correlation

You may have heard that cross-asset correlations are at levels that haven't been seen in decades, but what does that mean? Let's explore the idea and then look for some potential outcomes and opportunities.

Correlation:

This can be thought of as the degree to which 2 assets move together. The typical example involves 2 stocks - Company A (ticker ABC) and Company Z (ticker XYZ). The price of ABC is a function of the outlook for the company and the level and direction of the overall market. Similarly, the outlook for XYZ is related to its corporate outlook and the level and direction of the stock market. ABC and XYZ prices will change based on how each company is doing at its business. However, how stocks in general move will also have an impact on both ABC and XYZ. Generally speaking, the more the stocks move in a similar directions and by a similar amount, the higher their correlation. Stocks tend to experience higher correlation in times of market stress because investors shift their focus from the merits of a particular company to the risk of owning any stock. These concepts can now be applied across asset classes.

Cross-Asset Correlation:

The degree to which different asset classes move together is their cross-asset correlation. Asset classes that move in the same direction but without consistency have a low correlation. Other assets might go in different directions more often than not. For instance, the prices of stocks and bonds might generally move in opposite directions. This is otherwise known as having a negative correlation. As the price of stocks (generally) rises, the price of bonds (generally) declines. Sometimes price movements will be more pronounced and other times they will be less evident. Occasionally, the usual relationships will be overwhelmed and prices will move in the same direction. When that happens, cross-asset correlations are said to be rising. Most of modern finance is built on the idea that diversification improves returns while lowering risk but this breaks down when asset level

correlations are high, as they are now. In this kind of environment all assets are moving together so there is little differentiation in either risk or returns. This has a two-fold effect on investing. First, it reduces the benefits of diversifying holdings. Second, market professionals believe that this increases the risk of owning any asset due to the possibility of a dramatic return to lower correlations.

Where are we now?

Currently, all assets classes (stocks, bond, commodities, etc...) are rising, which is unusual and is described in the financial world by cross-asset correlation. It's worthwhile trying to understand why it's happening. There isn't an obvious answer. It may be that most investors are buying a particular asset class and the small number of traders in other markets are causing the anomalies. This would explain why volumes have been lower recently in the stock market. In low volume markets small (relatively speaking) trades will have a more profound impact on prices. Perhaps expectations about Quantitative Easing are forcing decisions that would otherwise be unwise. Many investors are anticipating that the liquidity injections caused by quantitative easing, also known as printing money, will be invested and that extra capital will drive up asset prices. This certainly appears to be the Fed's thinking. The push-pull of the inflation/deflation debate might be the cause. If the Fed starts printing large quantities of money, the outcome could be a significant bout of inflation. On the other hand, if home prices continue to erode and the economy stays weak, deflation might result. Market participants who fear inflation would gravitate to stocks while those who are protecting against deflation would want to own bonds. Whatever the reason, the next question is what to do about it?

What to do?

It is reasonable to expect correlations to return to more historical levels at some point. If this happens it could cause some asset classes to experience a shock as they move back to their traditional relationships. If deflation winds up being the dominant problem, then it is possible that bonds will perform better than stocks. Conversely, if the Fed is successful in igniting inflation, then

commodities and stocks will probably outperform yield based instruments, like bonds. We will explore that relationship in a future post.

For now, there are a few general take-aways.

First, correlations are unusually high at the moment.

This is probably the result of confusion among investors over the direction of the general price level and the impact that potential government programs are likely to have on them. It is unlikely that the current level of correlation will persist in the longer run, suggesting that certain asset classes have the potential to underperform, possibly dramatically, when the historical relationships reassert themselves.

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